

Client Understanding

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It is important to understand accounting jargon to increase accountability by firms, and ensure that their books of accounts reflect their true financial positions. This paper deliberates some of the terms whose understanding is important for firms that own different kinds of assets, such as building their own properties, or investing in property that has goodwill. The terms includes the adjusting goodwill for impairment; recording gain or loss on asset disposal; capitalizing interest on building construction, and adjusting the lower cost of market inventory on valuation.

Adjusting the Lower Cost of Market Inventory on Valuation

Understanding the significance of adjusting the lower cost of market inventory on valuation is crucial. According to the principle of conservatism; accounting rules require that inventory be reported on the balance sheet at its lower market value rather than the inventory's cost (Godwin & Alderman, 2010). This is known as the lower cost of market (LCM) rule. This rule is applied at the end of each accounting period by making a comparison of inventory costs with market values. Thus, for purposes of comparing the two, an inventory's market value is equal to the cost of replacing the inventory.

Firms also must understand how LCM is applied as they may need to compare costs and market values of their total inventories, some of their inventories, or individual inventory items. When the cost of the inventories is lower than the market value, the company should do nothing; but when the market value is lower than the cost, the company should adjust its inventory down to the lower market value (Godwin & Alderman, 2010).

The conservatism principle is used to break a tie between two options and is therefore used to judge if accountants can achieve this when presented with a scenario. For instance, if an

inventory item had cost \$20 but can be currently replaced at \$15, the conservatism principle states that the accountant should report the item in inventory to be worth \$15 and to further report a loss of \$5. On a side note, it is important to check the inventory regularly to determine company losses as a result of theft, damage, and deterioration.

Capitalizing Interest on Building Construction

Capitalization of interest is part of the cost of certain assets. For instance, when a business constructs a building over a period, the building qualifies for capitalization of interest. The amount of interest capitalized is the amount that could have been avoided in case the construction project had not been carried out (Delaney & Whittington, 2010).

Clearly understanding this topic is essential because when a firm constructs its own building or equipment, it recognizes the labor material as well as overhead costs incurred as an asset. The US Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS) require companies to include or capitalize interest costs during the construction process of a self-developed asset. The reasoning behind this is that firms must incur financing costs when they construct buildings on their own just as they must incur material and labor costs (Stickney, Weil, Schipper & Francis, 2009).

Firms base the amount of interest costs capitalized on the amount borrowed to self-develop the asset. This amount represents the interest cost incurred during periods of construction that the firm could have avoided by not building the asset. Capitalizing interest in the acquisition cost of assets during construction reduces otherwise reportable interest expense and thereby raises net income during periods of construction. This is important because in later periods, the self-constructed property will have higher depreciation charges, lowering net income. In addition, total expense over the life of the asset equals the cash expenditure, and thus